

BEFORE THE STATE OF RHODE ISLAND
AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

SURREBUTTAL TESTIMONY OF
CINDY Z. SCHONHAUT
ON BEHALF OF
COX RHODE ISLAND TELCOM, LLC

November 8, 2002

Docket No. 3445

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND POSITION.

A. My name is Cindy Z. Schonhaut. My address is 1020 15th Street, Suite 33C, Denver, Colorado 80202. I am an independent consultant to competitive telecommunications companies.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes. I filed direct testimony on behalf of Cox Rhode Island Telcom, L.L.C. ("Cox") on September 20, 2002. My background and qualifications are set forth in detail in that testimony.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to respond to the arguments presented in the rebuttal testimony of Theresa L. O'Brien, Arthur D. Silvia and William E. Taylor filed on behalf of Verizon New England Inc. d/b/a Verizon Rhode Island ("Verizon") with the State of Rhode Island and Providence Plantations Public Utilities Commission ("Commission") on October 22, 2002. Specifically, I respond to assertions regarding the competitiveness of the Rhode Island local exchange telecommunications market, geographic rate deaveraging, the use of imputation standards, and the funding mechanism for Internet access for Rhode Island K through 12 schools and libraries.

Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.

A. Verizon's rebuttal testimony does not change the fact that Verizon's Alternative Regulation Plan is overly broad and premature. If adopted, Verizon's proposed Plan, which includes tremendous new pricing flexibility, likely would establish serious anti-competitive conditions in the local telecommunications market. Contrary to Verizon's testimony, it will have both the incentive and the opportunity to target specific competitors. Competition in the Rhode Island telecommunications market is relatively nascent and not robust enough to withstand anti-competitive activity by the dominant incumbent provider. While Verizon's witnesses set forth grand economic theories about how the ideal market should work, they miss the reality that the telecommunications market is at a crossroads. (Taylor Rebuttal at 3-14). Numerous competitors are

struggling to survive and face serious financial constraints, a fact evident in falling stock prices and daily newspaper stories.¹ Given the highly unstable and uncertain state of the market, and especially given the significant level of flexibility Verizon has today to meet competitors' offerings, there should be no sense of urgency in adopting the proposed Plan. Such urgency is particularly unwarranted in light of Verizon's sound financial condition as evidenced by its earnings report for the third quarter of 2002,² which indicates the company is doing well. The Commission should not underestimate the serious risks to consumers and competitors that would result from adoption of Verizon's proposed Plan at this time.

Q. IN LIGHT OF VERIZON'S REBUTTAL TESTIMONY, HAS YOUR POSITION CHANGED REGARDING THE RISKS OF ANTI-COMPETITIVE BEHAVIOR?

A. No. Verizon's rebuttal testimony does not change the fact that the potential for anti-competitive behavior by Verizon, such as predatory pricing and price squeezes, would not be adequately disciplined by competition as it exists today in Rhode Island.

Q. DO YOU AGREE WITH DR. TAYLOR'S ANALYSIS UNDERLYING HIS CONCLUSION THAT ANTI-COMPETITIVE PRACTICES SUCH AS PREDATORY PRICING AND PRICE SQUEEZES COULD NOT RESULT FROM ADOPTION OF VERIZON'S PLAN?

A. No. Specifically, Dr. Taylor suggests that the current level of local competition would prevent Verizon from using downward pricing flexibility in a predatory manner. (Taylor Rebuttal at 3-5). The purpose of predatory pricing is for a company to eliminate competition while remaining profitable. Contrary to Dr. Taylor's testimony, however, remaining profitable does not mean that Verizon would be able to (or even would seek to) recoup every penny of lost profit due to below cost pricing. (Taylor at 5-6). Verizon simply would have to recoup enough money to remain profitable overall, while severely

¹ Kurt Eichenwald and Seth Schiesel, S.E.C. Files New Charges on WorldCom, N.Y. Times, Nov. 6, 2002, at C1; Barnaby J. Feder, Technology Briefing Telecommunications: Qwest Reports \$214 Million Loss, N.Y. Times, Oct. 31, 2002, at C4; Riva D. Atlas, Survey Finds Loan Losses Rose Sharply, N.Y. Times, Oct. 9, 2002, at C1.

² Christine Nuzum, Verizon Earnings Rise: Revenue Bolstered by Wireless, Dow Jones Newswires, Oct. 25, 2002. For the third quarter of 2002, Verizon reported earnings of \$4.4 billion, or \$1.60 per share. These earnings are more than double Verizon's earnings from the same period in 2001. While much of the growth appears to be due to wireless services, it is that very scope and breadth of Verizon's presence in the market - wireless as well as wired - that would provide it the opportunity to price selective services at below cost levels while still maintaining profitability.

damaging, if not eliminating opportunities for competition. Losing profits from certain services would not render a company the size and scope of Verizon unprofitable.

In his analysis, Dr. Taylor claims that existing competition would provide a sufficient check on possible predatory pricing by Verizon. (Taylor Rebuttal at 5-8). He states, in general, that the existence of competition will prevent Verizon from sustaining supra-competitive prices for a sufficient period of time necessary to recoup losses associated with previously pricing services below cost in an effort to drive competitors out of the market. What this argument ignores, however, is the greatest danger to the public interest inherent in Verizon's proposed Plan - the ability of Verizon to engage in selective pricing that could drive whatever limited competition exists today out of specific geographic or service markets. Dr. Taylor's theory also ignores other realities of the telecommunications market. Contrary to his assertions, current market conditions are volatile and competition is quite fragile, not only because of the situation in the financial markets, but also because of the pending resolution of important regulatory issues. Thus, while Dr. Taylor would rely on market forces to discipline anti-competitive behavior, Cox believes that the market is not sufficiently competitive to provide such discipline.

Q. WHAT ARE COX'S CONCERNS REGARDING THE MARKET?

A. Cox has two main concerns regarding the current market for local exchange services in Rhode Island: 1) the industry is in a state of serious financial trouble and dramatic upheaval; and 2) certain important regulatory issues that would have a significant impact on competition remain unresolved.

Q. WHY DO YOU BELIEVE CURRENT CONDITIONS IN THE TELECOMMUNICATIONS MARKET CREATE SERIOUS UNCERTAINTY ABOUT THE DEGREE OF LOCAL COMPETITION?

A. As indicated in Dr. Ankum's testimony (Ankum Direct at 33-37 and Attachment II), local competition and local competitors are experiencing seriously troubled times. One need only read newspaper headlines to see examples such as the recent bankruptcies of major telecommunications companies, including Global Crossing and MCI/WorldCom, the serious troubles facing Qwest, the allegations of fraud and criminal corruption at several major telecommunications companies, ongoing investigations by the U.S. Department of

Justice and the Securities and Exchange Commission, decreasing stock prices, and the difficulties of some companies in obtaining needed capital.³

Moreover, many smaller competitors - both existing and potential - have been eliminated from the market by bankruptcy or shrinking business plans. For example, in Rhode Island, at least two companies that once provided competitive services have exited the market: CTC and Network Plus. Dr. Taylor claims that, once a competitor exits the market, any facilities it has put in place can and will be used by another competitor. (Taylor Rebuttal at 4-5, 9 and 20-21). In reality, however, even new competitors that acquire the assets of failed companies do not necessarily become active in the market. For example, it is my understanding that although Broadview purchased the assets of Network Plus in Rhode Island, it appears to be merely maintaining service to existing customers and is not providing new or expanded services. Dr. Taylor might respond that economic principles dictate that the assets of Network Plus inevitably will be used by another company to provide service in competition with Verizon. The fact is, however, that such competition has not happened yet. Therefore, adoption of pricing deregulation for Verizon at this time would be premature at best.

Q. WHICH REGULATORY POLICIES REMAIN UNDECIDED THAT WOULD HAVE AN IMPORTANT IMPACT ON COMPETITION IN RHODE ISLAND?

A. Great uncertainty also lies in the fact that the pricing of unbundled network elements has not yet been settled in Rhode Island. The Commission's TELRIC proceeding has been held in abeyance pending a cost study filing by Verizon. Since the pricing of UNEs is of ultimate importance in determining the viability of UNE-based competitive entry, the Commission cannot evaluate the market without knowing what UNE rates will be available to competitors and whether competitors are able to use those rates to support sustainable competitive entry. The UNE entry strategy faces further uncertainty given that the Federal Communications Commission is reviewing its unbundling policies in the

³ Remarks of Chairman Michael K. Powell, Federal Communications Commission, at the Goldman Sachs Communicopia XI Conference, New York, New York, Oct. 2, 2002; Remarks of Chairman Michael K. Powell, Federal Communications Commission, at the Thomas Weisel Partners Growth Forum 4.0, Santa Barbara, California, June 17, 2002.

Triennial Review proceeding. All of these elements contribute to the great uncertainty in the telecommunications market in Rhode Island.

Q. CAN RESALE PROVIDE A CHECK ON VERIZON'S ABILITY TO ENGAGE IN ANTI-COMPETITIVE PRICING PRACTICES?

A. No. Resale in Rhode Island is a minor part of the telecommunications marketplace. Nationwide, resale as an entry strategy has consistently been found to be lacking in margin and success. In Rhode Island, it appears that only a couple of providers have used resale as an entry strategy and they provide very limited service offerings. As a result, resale is unlikely to provide any actual constraints on Verizon's anti-competitive incentives or behavior.

Q. WHY DO YOU BELIEVE EXISTING FACILITIES-BASED COMPETITION IS INSUFFICIENT TO PROVIDE A CHECK ON ANTI-COMPETITIVE BEHAVIOR BY VERIZON?

A. In my direct testimony, I stated that facilities-based competition in Rhode Island is broad but not deep. (Schonhaut Direct at 20; Silvia Rebuttal at 5-6). By that I mean that Cox's presence may well reach across the state but it has not yet begun to make significant inroads in penetrating the local exchange telecommunications market. Contrary to the assertions of Verizon's witnesses, Cox does not have a ubiquitous network especially when compared to the size and scope of Verizon's network. For a facilities-based carrier like Cox, even if its network passes by a building, a build-out may still be necessary to reach potential customers, especially potential business customers. Thus, large sums of capital and construction time are necessary for Cox to continue to expand its network. This is clearly a competitive disadvantage that Verizon does not face.

In addition, Verizon's witnesses appear to exaggerate the extent of Cox's presence in the local exchange telephone market in Rhode Island. For example, Ms. O'Brien relies on claims that Cox provides service to malls and municipalities. (O'Brien Rebuttal at 5-6). While Cox would certainly like this to be the case, in reality Cox serves one mall out of several in the state and a handful of municipalities.

Moreover, contrary to Mr. Silvia's contentions the mere presence of a competitor, or competitors, in a central office or in a rate center, provides no indication of the extent of competition in that rate center or in the state. (Silvia Rebuttal at 3-7). A competitor may have established a presence in a Verizon central office through collocation, but may not yet be providing service, let alone to a significant degree. Mr. Silvia may be correct in theory that such collocation would give competitors access to end users in Rhode Island, but that does not mean those end users actually are receiving service from competitors rather than from Verizon.

Q. DOES COX HAVE ANY OTHER CONCERNS RELATIVE TO DR. TAYLOR'S ASSERTIONS REGARDING THE MARKET?

A. Yes. Dr. Taylor's theory regarding the ability of the competitive market to constrain anti-competitive behavior not only fails to recognize the reality of the market but also the uniqueness of the market in Rhode Island. Generally, three types of market entry exist in a competitive market. They include UNE, resale and facilities-based providers. It is my understanding that the level and mix of the competitive entry in Rhode Island differs from many other markets around the country. In Rhode Island, UNEs as a mode of entry is not as strong as in other states and the possibility for future growth in competition is unclear given the uncertainty surrounding the pending UNE proceeding. There is also very little resale competition in Rhode Island. While Cox has managed to provide a certain degree of facilities-based competition, that competition standing alone is not sufficient to constrain anti-competitive behavior. In fact, it is arguable that, given adoption of Verizon's proposed Plan, any effective facilities-based competition would immediately become the target of any Verizon anti-competitive efforts, thus further reducing any constraint against anti-competitive behavior that facilities-based providers were able to bring to bear. Thus, in reality, the market is not sufficiently competitive to prevent Verizon from engaging in anti-competitive behavior.

Q. DO YOU AGREE WITH ARGUMENTS IN VERIZON'S REBUTTAL TESTIMONY THAT CUSTOMER-SPECIFIC PRICING WOULD BE BENEFICIAL TO CONSUMERS?

A. No. Customer-specific pricing, including geographically deaveraged rates, are clearly anticipated by the proposed Alternative Regulation Plan. While some degree of pricing flexibility exists today, it is the complete pricing flexibility inherent in the proposed Alternative Regulation Plan that raises competitive and public interest concerns. Customer-specific pricing, including geographically deaveraged rates, of the type proposed in the Alternative Regulation Plan could result in rural customers paying more for local service than urban customers, which is contrary to existing expectations regarding appropriate rural rates.

Q. DO YOU HAVE ANY COMMENTS ON VERIZON'S REBUTTAL TESTIMONY REGARDING THE ADOPTION OF AN IMPUTATION STANDARD?

A. I do. I disagree with Dr. Taylor's belief that the establishment of price floors, based on an imputation standard, would not be in the public interest. (Taylor Rebuttal at 11-14). As stated in my direct testimony, Cox supports the establishment of price floors using an imputation standard that would set the floors at levels equal to TELRIC-based rates for UNEs. The imputation standard is important as it allows the Commission to prevent anti-competitive behavior on a pro-active basis. Price proposals would be reviewed in relation to the imputation standard, allowing the Division to further monitor impacts of the proposal if adopted by the Commission and to step into the process as necessary.

Dr. Taylor also argues that if an imputation test is adopted, the Commission should use a different test than the one proposed by Dr. Ankum. (Taylor Rebuttal at 11-14). Cox requests that the Commission order the parties to develop, collectively, an appropriate imputation standard. If pricing flexibility were adopted, such an imputation standard would provide protection for consumers and competition that cannot otherwise be obtained.

Q. BASED ON VERIZON'S REBUTTAL TESTIMONY, DOES COX HAVE ANY ADDITIONAL RECOMMENDATIONS REGARDING FUNDING OF INTERNET ACCESS FOR SCHOOLS AND LIBRARIES IN RHODE ISLAND?

A. No. In my direct testimony, I propose that the Commission refer this issue to another proceeding. Verizon's rebuttal testimony does not change my conclusion. Rather, the testimony from the various parties highlights the fact that the funding mechanism for Internet access for schools and libraries is a complex issue and one that deserves more detailed fact finding and discussion in a separate proceeding. (O'Brien Rebuttal at 6-7; Taylor Rebuttal at 15; Weiss Direct at 20-21).

Q. DOES VERIZON'S REBUTTAL TESTIMONY WARRANT ANY CHANGES TO COX'S RECOMMENDATIONS TO THE COMMISSION?

A. No. Cox stands behind its recommendation to the Commission in my direct testimony. As discussed above, Cox believes there is real harm in the Commission rushing to judgment on the future competitiveness of the telecommunications market in Rhode Island. Cox is not advocating that the Commission never adopt alternative regulation for Verizon, just that the Commission take a slower approach and not adopt Verizon's proposal at this time. While moving too fast could have disastrous consequences for competition in the telecommunications market, a more cautious approach will not hurt Verizon, whose earnings continue to grow as evidenced in its most recent earnings reports, in spite of troubles in both the economy and the telecommunications industry.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes.